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To: The Honorable Sylvia Luke, Chair
and Members of the House Committee on Finance

Date: Thursday, March 19, 2015

Time: 2:00 P.M.

Place: Conference Room 308, State Capitol

From: Maria E. Zielinski, Director
Department of Taxation

Re: S.B. 1133, S.D. 1, Relating to Conformity of the Hawaii Income Tax Law to
the Internal Revenue Code

The Department of Taxation (Department) strongly supports S.B. 1133, S.D. 1, an Administration measure. S.B. 1133, S.D. 1, conforms the Hawaii income tax law to the Internal Revenue Code (Code) as of December 31, 2014.

Section 235-2.5(c), Hawaii Revised Statutes (HRS), requires the Department to submit legislation to each regular session of the legislature to adopt the Code as it exists on December 31 preceding the regular session.

S.B. 1133, S.D. 1 amends section 235-2.3(a), HRS, to conform the Hawaii income tax law to the operative Code sections of subtitle A, chapter 1, as amended as of December 31, 2014. Generally, subtitle A, chapter 1, refers to Code sections 1 through 1400T.

The United States Congress enacted the following tax measures during 2014, which the Department analyzed to determine if amendments to conformity were necessary:

1. "Corporate and Small Employer Charity Pension Flexibility Act," P.L. 113-97, enacted April 7, 2014;
2. "Highway and Transportation Funding Act of 2014," P.L. 113-159, enacted August 8, 2014;
3. "Tribal General Welfare Exclusion Act," P.L. 113-68, enacted September 26, 2014;

4. "Consolidated and Further Continuing Appropriations Act," P.L. 113-235, enacted December 16, 2014;
5. "Tax Increase Prevention Act of 2014" and "Achieving a Better Life Experience Act of 2014," P.L. 113-295, enacted December 19, 2014.

The Department identified one necessary change for conformity. The Achieving a Better Life Experience Act of 2014, created Code section 529A, to allow states to create tax-preferred savings plans for the benefit of disabled individuals. The plans, called ABLE accounts, are similar to Code section 529 qualified tuition programs in that withdrawals are tax free if used for qualified expenses, but subject to income tax and a ten per cent penalty if not used for qualified expenses. Hawaii does not conform to the ten per cent penalty for 529 programs. Therefore, the Department recommends not conforming to the ten per cent penalty on 529A ABLE accounts.

Section 3 of the bill contains an amendment to section 235-2.4, HRS, to add a new subsection (dd) to provide that Hawaii does not conform to the ten per cent penalty on nonqualified withdrawals from 529A ABLE accounts.

Thank you for the opportunity to provide comments.

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SUBJECT: INCOME, Conformity to Internal Revenue Code

BILL NUMBER: SB 1133, SD-1

INTRODUCED BY: Senate Committee on Ways and Means

BRIEF SUMMARY: Amends HRS section 235-2.3(a) by changing the date references to make the Internal Revenue Code (IRC) applicable for state income tax purposes as it was amended on 12/31/14 for tax years beginning after 12/31/14.

Amends HRS section 235-2.4 to make section 529A (with respect to qualified able programs) of the Internal Revenue Code operable for state income tax purposes; provided that section 529(c)(3) shall not be operative.

EFFECTIVE DATE: Tax years beginning after 12/31/14

STAFF COMMENTS: This is the annual conformity measure submitted by the department of taxation TAX-01 (15) in compliance with HRS section 235-2.5 which requires the department to annually submit a measure to maintain state income tax conformity with the federal Internal Revenue Code. The purpose of conformity is to update the state income tax laws with respect to the definition of income with those changes made to the federal Code during the past year and to adopt those changes that are appropriate for Hawaii law.

For those unfamiliar with the operation of the conformity statute, the federal Code is adopted by exception, that is Chapter 1 of subtitle A of the Internal Revenue Code is adopted with the exception of the various Code sections listed in HRS section 235-2.3. Thus, if the Code section is not listed there, it is operative for state income tax purposes. In some cases, Code sections are operative with certain limitations as noted in HRS sections 235-2.4 and 2.45 where provisions like the standard deduction are operative, but the state law inserts different amounts for state income tax purposes. Prior to the adoption of the current statute in 1978, changes to the federal Code were adopted by referencing the specific Public Laws of the various sessions of Congress that made those changes. This was a tedious and cumbersome way to adopt the changes to the federal Code as one had to have the specific Public Law in order to understand how a certain tax provision applied for state income tax purposes. Although it might seem simpler for the legislature to adopt the Internal Revenue Code as it exists now and in the future, it is not constitutional to do that because lawmakers have the power and duty to determine which federal amendments, if any, to pick up for state purposes.

It should be noted that a number of Code amendments in the last few years focused on incentives to help jump start the economy with a variety of tax credits. Generally, Hawaii does not adopt these tax credits for state income tax purposes as these credits are a direct reduction of tax liability. Since federal tax rates are higher than state income tax rates, these credits are usually much more generous than what Hawaii can afford.

The proposed measure makes section 529A (with respect to qualified able programs) of the Internal Revenue Code operable for state income tax purposes. With the passage of the Achieving a Better Life Experience Act of 2014 (ABLE), accounts similar to a 529 college savings account are allowed to be established and used for qualified disability expenses which may include education, housing, and transportation. Earnings of these 529A accounts are tax free.

Digested 3/18/15